

July 20, 1977

LETTER 703

July 8, DJIA 907.99; PTI 882; A-D ratio -19.97
July 15, DJIA 905.95; PTI 884; A-D ratio -17.87

THE MARKET: People tend to be greedy and fearful, and this leads to a strange process. They believe what they *want* to believe. Thus, during periods such as late-1965 and late-1972 we saw the D-J Industrial Average outperform the breadth of the market. At that time, since everyone *wanted* to be bullish, it was held that the Dow was a marvelous device, and analysts noted that it was incredible how faithfully the Dow paralleled other much broader and "more representative" Averages.

Today, we find that the tables are reversed. People again *want* to be bullish, so it is widely held that today's weak Dow is a deception and a fraud, and the "true market" is being reflected in such barometers as the advance-decline line, the Value Line Average or the Indicator Digest Average.

The "answer," if indeed there is a single answer, is that neither side is thinking very clearly. In this business, I have to deal with facts and make sense—or I don't stay in business. And as I see it, the operative set of facts is that in all history any divergences in the major indices and Averages have always been corrected. Furthermore, it is the indicator which is *most persistent* and stubborn in its divergence which eventually leads the way.

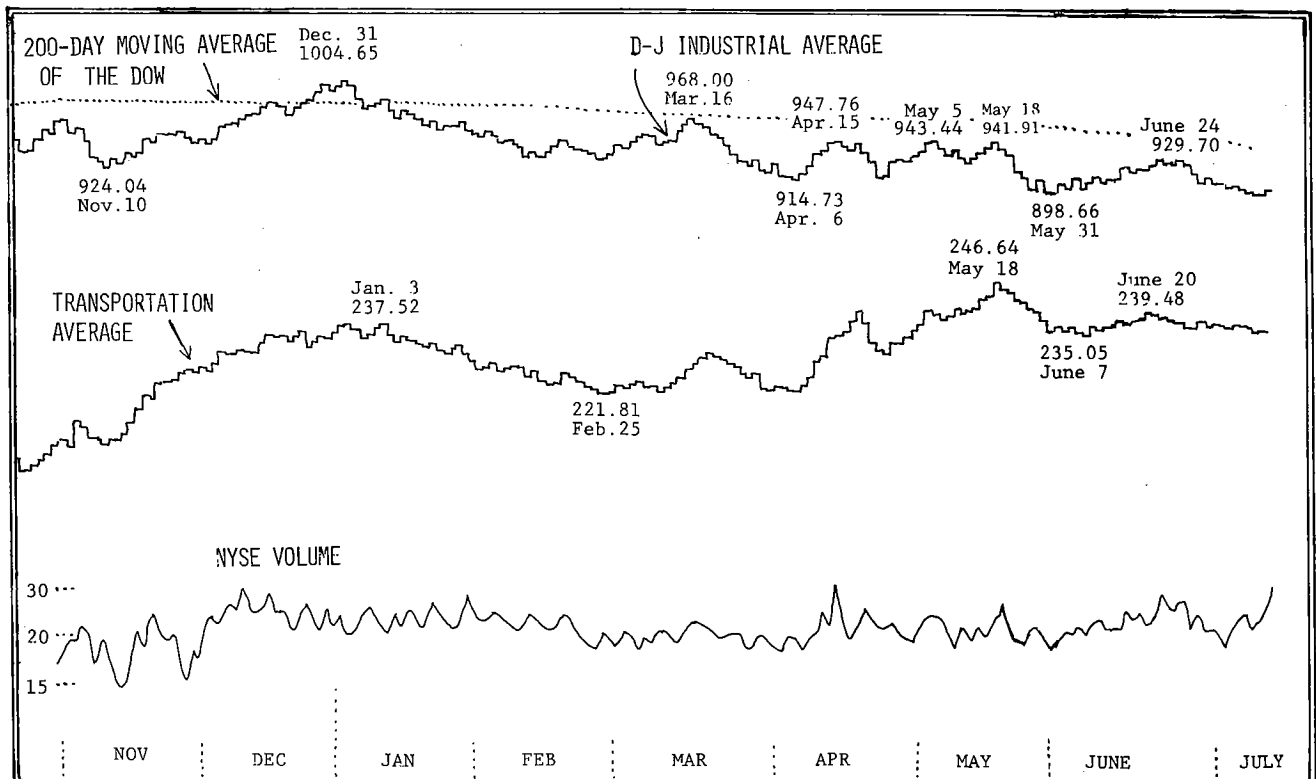
In the meantime, the Dow continues sloppy, weak and down while the A-D ratio continues to flirt with its bull market highs. But again, I must warn subscribers that any time the *trend* of the Dow is down, it's a tough market to make money in—and a dangerous one. In fact, a dramatic example of what I am talking about occurred on the week ending July 8. On that week

advances outnumbered declines by 1013 to 751. Yet the Wilshire 500 Equity Index (which measures the *dollar value* of all NYSE stocks, all AMEX stocks and many leading OTC stocks) dropped by a value of \$7 billion! That gives us some idea of where the big money is; and to put it bluntly, it's in the IBM's and the GM's, not the "hundreds of little fellows" on the various exchanges.

Furthermore, the Dow seems also to be reflecting what's happening in the major stock *groups* and by "major groups" I mean the ones that produce the cycles in the economy. For instance, according to my analysis, the following stock groups are either in trouble or have topped out; Automobiles, Chemicals, Copper, Forest Products, Paper, Steel, Textiles. The groups that remain the strongest are the financially oriented ones together with the broad utility complex.

PRICE MOVEMENTS: Turning to the page 1 chart of the D-J Averages, we can see that the period of *divergence* in the Averages is moving into its tenth month. This constitutes one of the *longest* periods in stock market history in which the two D-J components have followed separate paths.

The divergence reached an extreme in late-May. On May 18 the Transportation Average recorded a closing bull market *high* of 246.64. On May 31, eight trading days later, the D-J Industrial Average struck 898.66, its *lowest* closing level in 17 months. Following that most extraordinary performance, the Averages seemed to retreat as if to survey the situation.



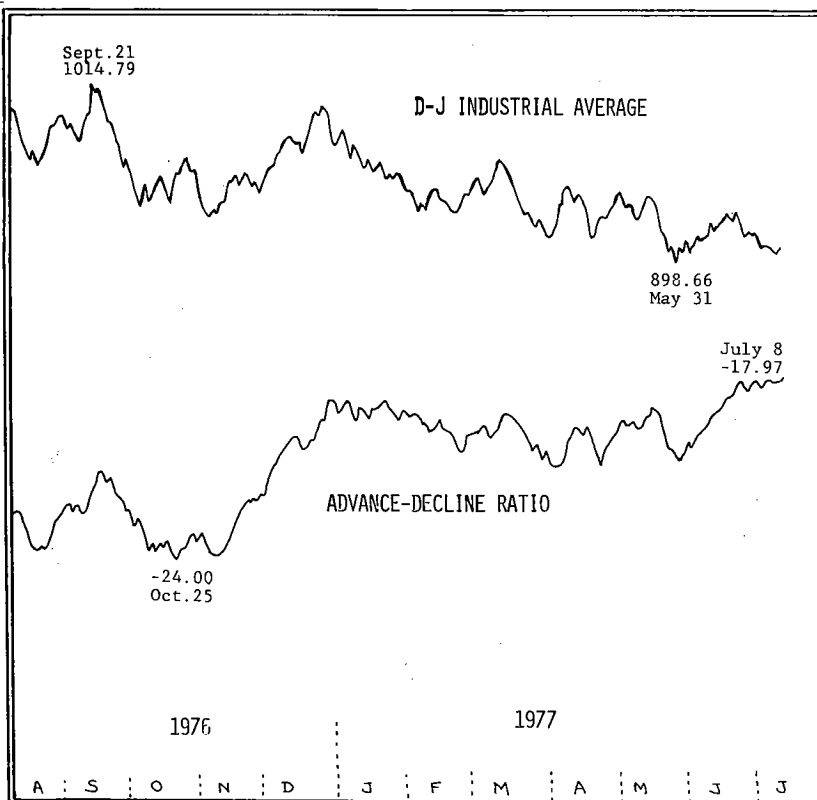
While Industrials held above their 898.66 low, Transports slid to a low of 235.05 (June 7). From here a dull rally commenced. The peaks for the rally were reached on June 20 for Transports at 239.48. Industrials touched their rally high on June 24 at 929.70.

The rally, half-hearted as it was, did point up one new factor. And that factor was that the Transports, following a year of outstanding strength, had finally turned weak. Note on the May-June decline that Transports hit their low AFTER the Industrials recorded its 898.66 low. That was a sign of Transport weakness. On the ensuing rally, Transports recorded their high (239.48) BEFORE the Industrial high of 929.70, a second indication of Transport weakness. Furthermore, it is clear on the chart that the Transport rise (in percentages) failed even to match the rather dull Industrial rise.

In the last Letter I noted that the D-J Industrial Average has been the weak link in the market chain all year. Only Transport strength and the many Transport non-confirmations (on the downside) have kept the market's price structure intact. If the Transports are now turning weak, we could have trouble ahead. I base this statement on the simple principle that if first one Average, then the other, turns weak, we have a very weak market as far as the Dow Theory is concerned.

I further stated in the last Letter that "in my opinion, the strength or weakness of the market will be measured by the ability of ONE OR BOTH Averages to hold above the 898.66 (Industrials) and 235.05 (Transports) lows." As of this writing, despite much backing, filling and sliding, the lows have held intact (see page 6 for LATE NOTES).

If one or both Averages can hold above the 898.66 and 235.05 levels, the stage will be set for the next rally attempt. My studies show that the market at this time is still far from "over-sold," and this militates against any important upside action in the Averages.



It is interesting to note that no important advance in the Averages has appeared in 1977, and this in itself is an extraordinary situation. My own experience suggests that when such a long period of time elapses without an important advance, it is almost a prerequisite that the market become **over-sold**. The over-sold condition is one in which the Averages drop to a level in which the speculative element is obviously squeezed out of the market. This has simply not come to pass in 1977.

From the Dow Theory standpoint, the Industrial Average is still in the grips of a long downtrend which began at the September 21, 1976 bull market peak of 1014.79. A lower peak of 1004.65 occurred on December 31, followed by 968.00 on March 16, 947.76 on April 15, 941.91 on May 11—and the latest peak of 929.70 which appeared on June 24.

The Transports have now traced out a potentially bearish pattern with a recent bull market peak of 246.64 recorded on May 18, 1977, and a lower peak of 239.48 on June 20. Any break below 235.05 would result in a bearish downward "zig-zag" structure in the carriers, something not seen so far in 1977.

From the bull's view, the first indication of an authentic bull attack would be a **joint** push above the mid-June peaks, Industrials above 929.70 and Transports above 239.48. For the edification of newer subscribers, I will repeat that a penetration of a single Average, unconfirmed by the other, is meaningless for predictive purposes—and very likely to be deceptive.

Conclusion: The long divergence in the Averages continues, but the potential for a downtrend in both Averages is looming. A joint violation of 898.66 and 235.05 would point the secondary trend of the market decisively downward. But even if the 898.66 and 235.05 lows hold, I am skeptical of this market's ability to mount a major advance from this area. The over-sold technical conditions for a base are still lacking—as they have been all year.

FURTHER COMMENTS: There is no question in my mind but that the outstanding technical prop under the market in 1977 has been the powerful performance of the Utility and Bond Averages. As of this writing, the D-J Utility Average has rallied above its bull market high to record a new high in the 117 area. At the same time the D-J 20 Bond Average is currently at 92.74, within striking distance of its 1977 bull market high of 93.37.

As described in previous Letters, a bullish trend in Utilities and Bonds provides a very positive under-structure for the stock market. Thus, the sterling Utility-Bond performance has gone a long way towards equalizing the bearish indications of the Industrials and Transports.

Furthermore, the advance-decline ratio continues to flirt with its bull market highs, and this indicator also has been belieing the weakness in Industrials and Transports. The accompanying (daily action) chart shows the period of September, 1976 to the present. During this period we have seen one of the *longest and most persistent price-breadth divergence in the history of Wall Street*.

There are actually **only two comparable situations** in all market history, the 1934 instance (which was much shorter in duration than the present one) and the 1940-41 instance. In both of these examples, the A-D ratio *diverged upward against a persistently declining trend in the Dow*.

During early-February, 1934 to April, Industrials sagged while the A-D advanced sharply. This action was followed by irregular downside action until March, 1935. After that the market surged steadily upward to its final 1937 bull market high.

During May to November, 1940 the A-D far outperformed the Dow. A reaction began in November and carried into April, 1941. From April of 1941 to September of that year the A-D again outperformed the Dow. This divergent action was followed by a long slide into April, 1942. Following the '42 bottom the market turned up (a new bull market) and embarked on the greatest breadth (A-D ratio) advance in modern history.

Thus it is seen that in both previous instances, the divergence in which breadth outperformed price was (1) followed by considerable irregularity and ultimately by a big correction. (2) Both previous divergences occurred within bull markets, and in each case the corrections were followed by major rises in both the A-D ratio and the Dow.

If history is to repeat, we might expect (1) a costly reaction to follow the current extraordinary period of price-breadth diver-

gence, and (2) the reaction would be followed by a major (even historic) bull market advance in both the Dow and the majority of stocks, as measured by the A-D ratio.

NOT EASY: Shown here is my chart of four leading stock averages. Each is a composite or a broad average of a good many different stocks in a number of industries. My thesis ever since I first published this chart is that broad market moves, valid moves, will be confirmed on all four of these composites.

For instance, note at the recent May, 1977 lows (marked X on the chart) that the NYSE Composite and the S&P Composite broke below important preceding low points. These penetrations were not confirmed by either the Value Line Composite or the D-J 65 Stock Average. The result was that there was no follow-through, and the market subsequently recovered and continued to hold within its narrow range of the past 17 months.

Over the last few weeks, the Value Line Composite has pushed to a new bull market high, but this high has not been confirmed by the other three Averages. Thus, Value Line may be "leading the way" but in my experience, unless the other composites confirm on the upside, it will be a lead that is more deceptive than useful.

Because of the long stalemate, because "line" formations in the averages are so difficult, and because bonds are so attractive, I have recommended that subscribers move out of most stocks and into high-yielding bonds. I realize that this procedure is not as exciting as being loaded with equity, but I believe that it makes more sense for the moment.

My first thesis in this section is that all four of the composites will confirm during valid price movements. I have a second thesis: it is very difficult to make money with a portfolio of stocks when the four composites are not in definite, upward trends.

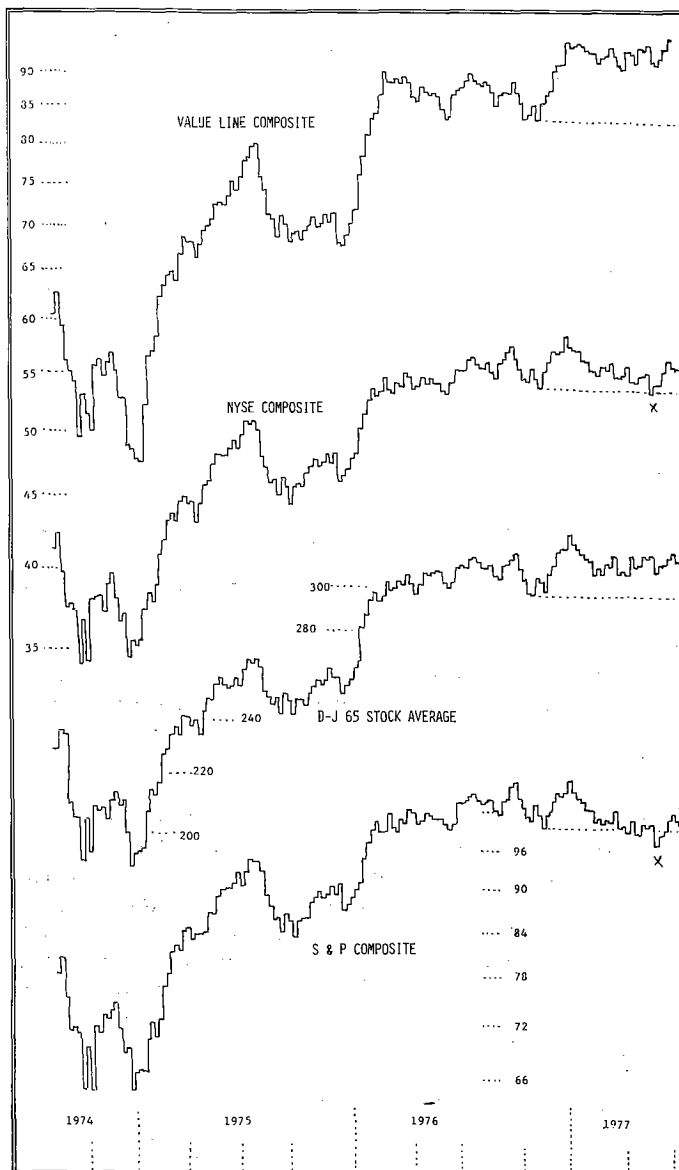
I realize, of course, that there is always the bright boy, the lucky guy or the brilliant tactician who can make 20% on his money while the major composites move sideways or even down. But the odds say that if you own 10 stocks, 8 out of the 10 will go up when the four composites break out to new highs, and 8 out of 10 of your stocks will go down when the four composites break important preceding low points.

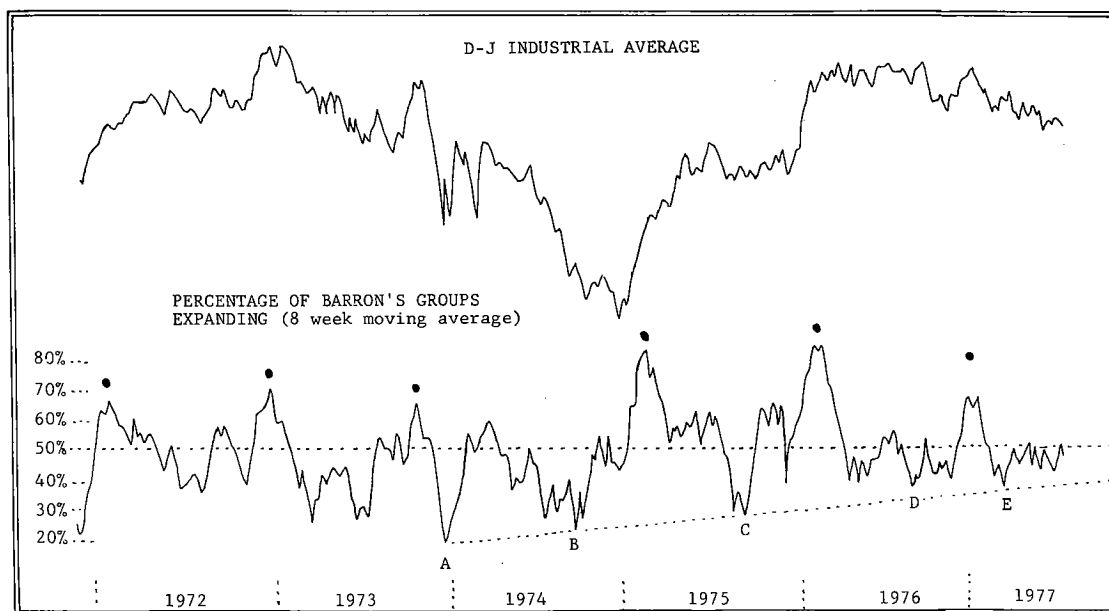
GROUPS: I have been watching one of my technical studies closely, because I feel that it could be telling a story (chart is on page 4). This is an oscillator based on the action of the 34 Stock Groups listed weekly in Barron's (the gold group has been eliminated from this study because it tends to be contracyclical).

The composition of this oscillator-index is simple. Each week the number of stock groups that have advanced are counted, and this is treated as a percentage. For instance, if 10 of the Barron's 34 groups showed a plus for the week, the advancing percentage would be 29%. These weekly percentage figures are then smoothed out in the form of an eight week moving average. And that's what we see on the chart.

One interesting facet of this study is that the peaks and valleys in the index tend to come roughly *one year apart*. Occasionally there is an irregular series such as in 1974, but in 1975 we had the usual one-year interval again.

I have marked all the peaks in the index with a black dot. Note that there were powerful peaks in early-1975 and early 1976.





Both of those peaks moved over the 80% level. In early 1977 (the most recent dot) the index recorded a rather *weak peak* at 68%. This was the weakest high of the bull market so far. Since then the index has been backing and filling in the 40-50% area.

There are two factors that I am now watching. The first is that this index "should" be gathering strength for a new peak around the end of 1977 or perhaps early 1978. That period should represent the peak of upside action for the 34 Barron's Stock Groups. For this reason, it will be most important to watch the strength (or lack of strength) during the next five months.

According to the group index, we are moving into the area which should produce a bottom, and then a rise culminating in a peak of group strength around late-1977 or even early-1978. I am particularly interested in this study because it coincides with my previous studies (Letter 696, page 4) which pinpoint October, 1977 as a key month. I wonder if October could not produce a major market bottom, and the group index seems to fit into that concept.

Another most interesting facet of the chart is this. Ever since late-1973 the bottoms on this index have been rising. I have labeled the bottoms from A to E successively. This should be a powerful argument for market strength, since it means that each decline in the Groups Advancing Index has been "less weak" than the last. Ordinarily, in the wake of this kind of action, I would expect the whole series (from A to E) to wind up with real strength on the upside. So far this has *not* occurred, but it may yet develop.

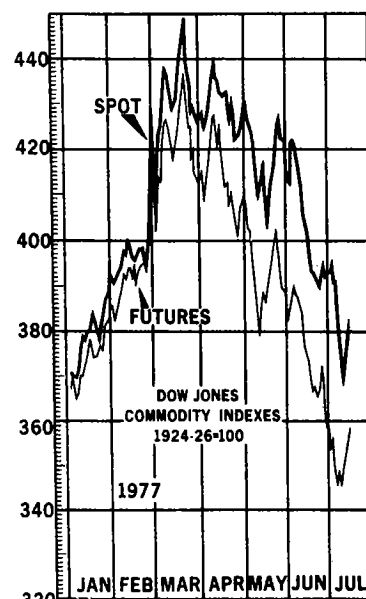
My own feeling is that the general market (and of course the various stock groups) are being "double-crossed" by the extraordinary weakness in the Dow. If the remainder of the cycle on this index cannot get the Dow going on the upside, then I would say this market is in danger of a very severe secondary reaction. If such a correction occurs, it will be most important to see whether the four-year rising trend of bottoms (A to E) in this index hold. If it does not, then I would guess we will get a downside slide of severe proportions. It would be a slide that would take almost **ALL THE STOCK GROUPS** with it—hopefully to a major bottom during the next two to three months.

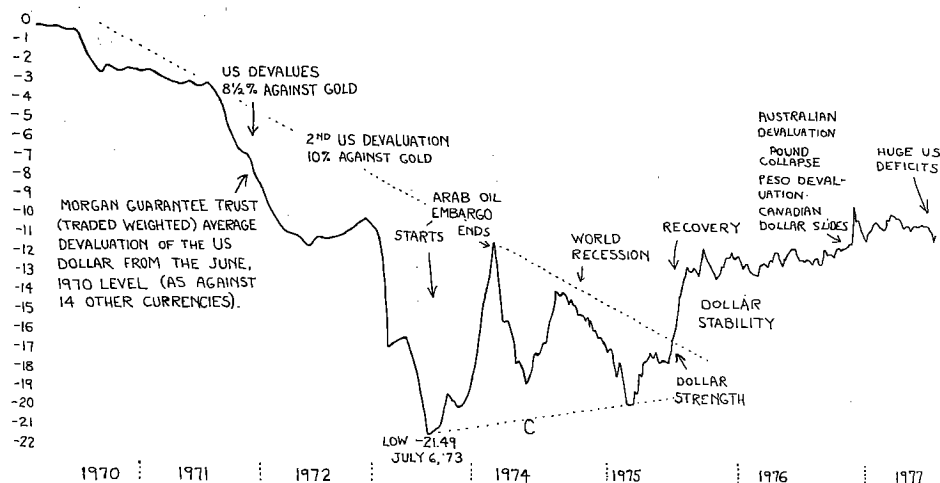
DOLLAR'S DIVE: Many analysts have comforted themselves by calling the current smash in commodities a technical phenomenon. To which I say, "forget it." Something is happening here, and it isn't a market "adjustment." I think the commodity smash is part of the deflation syndrome that I've been talking about for over a year. At any rate, when commodities slide the way they've been doing, we know one thing for sure—it sure isn't inflationary.

Now look at the chart on page 5. It's a chart you don't see very often, and it's the progress of the dollar against a basket of 14 other currencies. Mind you, this is not a chart of the dollar against the strong Swiss franc or the powerful Japanese yen, it's a chart of the dollar against a lot of other currencies, and the fact is that the dollar has now turned very weak.

Classically, a weak currency will bring in higher interest rates as the government seeks to defend its currency. But the Carter Administration isn't your orthodox crowd. In what seems like a declaration of war, Treasury Secretary Blumenthal recently told the strong currency nations (Japan, Germany, Switzerland) that what was needed was deficits on their part. Since these nations all take a dim view of inflation, their respective leaders probably wonder what kind of idiots have taken over in the hallowed halls of Washington.

Therefore, with President Carter and the boys "committed" to low interest rates (and with hard-money Fed Chairman Burns up for reappointment), I doubt that the US budget battle will be fought via the classical route of higher interest rates. In fact,





I'm not sure the US battle will be fought at all. Next, we may maybe hear Mr. Blumenthal say, "Let the dollar sink; US exports will then simply be bigger bargains for our foreign accounts. And as far as foreign investments in the US are concerned, the hell with them. After all, foreigners are pumping their money into the US for safety reasons—and where else are they going to go, to Red China! The dollar will find a floor, and if the price of a Datsun Pickup goes to \$10 thousand, well, we Americans will simply buy Pinto's."

But here's the problem I've been mulling over. Say you're a wealthy German, and you've put a nice chunk of your money into an assortment of blue chip Dow Industrials. You've been watching what I term "the double whammy." You've been watching the price of your stocks go down, and you've also been watching the dollar value of your stocks go down in terms of German marks (even when the stocks manage to stand still in terms of dollars). You've experienced a mild feeling of panic in your throat as you call your German broker. "Hans," you gasp, "I can't hang on any longer in the crazy American market; sell me out!" And that could be just about what's happening.

And now for that great mystery entitled, "Why isn't gold roaring up in the face of a weak US dollar?" And my answer is the same as it's been for the past six months. I think the current dullness in gold is a function of deflation. A few years ago, if the dollar was as weak as it is now, gold would have gone through the roof. But today's investors are looking at the new forces of deflation, and they don't seem in any hurry to hedge with gold purchases. The forces of inflation and deflation are now banging into each other head on. And the result is a listless gold market.

Next, the bond market: why are bonds tending to hold with the dollar this weak? Ordinarily, bonds would be heading down in the face of a weak dollar and in the face of potentially higher interest rates. But again, I feel that the opposing forces of deflation are exerting a positive influence on bonds (even while the weak dollar is exerting a bearish influence). Result, hopefully, should be a stalemate for US bonds (rather than a major decline).

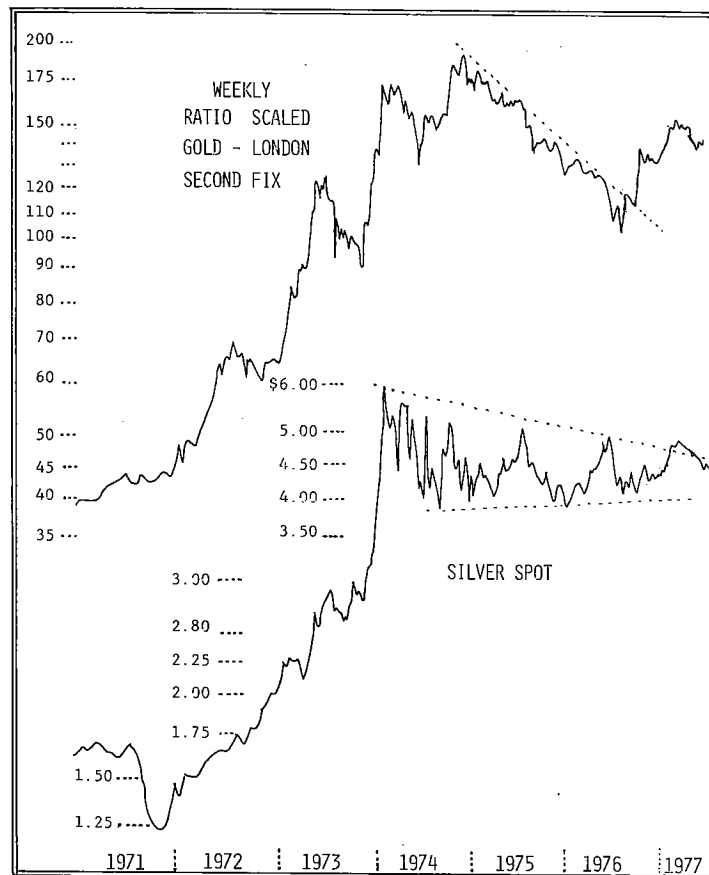
Speaking of gold (and silver), the accompanying chart shows the progress of the two precious metals over the past seven years. I think one thing that is confusing many hard money investors can be explained by the following: the big 1971-74 bull market in gold was brought on basically by a massive catch-up in gold, following 40 years of "fixed price manipulation" by the US Government. When the lid came off in the free market, gold made up for four decades of inflation with a rise from \$35 to \$200.

The big adjustment upwards ended in late-1974. Today, in the 135-150 area, gold is priced about where "it should be." The only thing that would give us a big new bull market in gold is a fantastic collapse in the dollar via wild inflation. But with the current deflationary forces appearing in world markets, gold is literally standing still.

Silver has been fluctuating within the huge triangle which has been forming since 1974. A few months ago silver broke above the triangle, but the break-out was very weak, and as you can see there was no follow-through. SO—although I continue to view precious metals as a holding worth perhaps 5% up to 10% of assets, I do not expect any big move in gold or silver over the foreseeable future.

From the international viewpoint, it is worth noting this fact: of the 19 major stock markets in the world, only 6 of those 19 show a plus reading in their stock averages for 1977 so far. Of the 6 winners, 3 show a loss in their currency against the dollar (the three are Holland, Denmark and Canada). Of the 19 countries, 11 show a loss in their currency value against the dollar. Consider this; a German who invested in the Dow on January 1, 1977 now shows a loss of about 20% of his capital! Why, because the Dow is down about 10% and the dollar is down about 10% in terms of marks.

THE DREAMER'S TALE & OTHER ITEMS: One bright morning President Carter woke up, sat up in bed and exclaimed, "It doesn't work! I've tried it and it doesn't work. I kept taking



money from the rich and giving it to the poor. But the poor never got any richer—and the rich just got poorer.” This thought so excited the President that he immediately progressed to the next thunderclap. “I’ve got it, I’ve got it,” he screamed, gripping the side of his giant White House bed, “you have to produce capital and savings rather than take it away! By Gad, it’s simple! When business is profitable, it hires more people, and when those people feel good and save more and buy more, then the whole country starts glowing like a lit up Christmas tree.”

Finally, the entire picture burst like a bomb on Carter’s consciousness. “I’m going to stop grabbing all the corporate profits and rich men’s money. I’m going to get the Government out of everybody’s hair. I’m going to declare war on red tape and Government spending and political pork-barreling. I’m going to go down in history as the ‘Prosperity President’.” And lo, a White House orderly heard what the President said, and the orderly called his broker and told him what he had heard. And the broker told his house analyst and the analyst told everybody—and the market bottomed out and headed up for what was to be the biggest advance in the history of the NYSE.

In a recent *US News & World Report* interview, IRS Commissioner Kurtz stated that the next area for Government taxation will be the fringe benefit. For instance, if you are receiving free parking or free airline passes, this is the area your IRS will be looking into. Said Kurtz, “I take a very broad approach. I believe they’re (the free benefits) basically taxable. Economic benefits that are received as a result of employment are taxable income.”

I’ve been writing a good deal about the corporate profit sharing and pension plans. In my opinion, this is the only major financial area in the nation where capital formation is actually going on. We can see it in the figures. Since 1970, individual ownership of all US stocks has dropped from 67% to 53%. Mutual fund ownership of stocks during the same period has dropped from 6% of the total to 5%. But private pension fund ownership of US stocks has risen from 7% to 11.5%. State and local retirement funds have increased stock ownership from .8% to 3.2%. The reason for the massive increases, of course, is tax deferral. In 15 years the pension funds will control the private sector of the economy. Which may just be a good thing! When the workers have a vital stake in corporate profits, they may just turn into capitalists (that’s if there is any capitalism left at that time).

LATE NOTES & COMMENTS: I just received a note from Mr. S. H. Dike (1420 Carlisle Blvd. NE, Albuquerque, NM 87110). He does some of the best work I’ve seen on the market, and his letter to me says, “I have never seen a more ‘mixed up’ market in over 12 years of analyzing it by computer.” If Dike’s computer can’t spot a broad trend, then there just isn’t one.

Today’s market reminds me of a comment I made early last year regarding the sudden proliferation of trend-following and timing advisories. I said that I thought market timing had become much too “fashionable,” and that the whole timing concept was probably headed for trouble. This is indeed what has happened.

At this time, any analyst can prove just about anything he wants regarding this market. If you’re bearish, you can point to the Dow or to the broad composite averages, which have done nothing of late. If you’re bullish, you can point to the A-D ratio or the Value Line or Indicator Digest (unweighted) averages or you can talk about bonds or utilities.

My own feeling is that advisors (and their customers) get too caught up in tactics and being “smart,” rather than what they are trying to do—which is, of course, **handle money intelligently**. I have felt that bonds, at present, serve as a good place to sit and watch with the bulk of our funds, in lieu of “sweating out” the conclusion of the Dow—A-D ratio battle that is currently raging. I guess it boils down to whether you would rather be a genius and beat the market or whether you would rather be an investor and collect interest while the technical market problems are being settled. Another thought which occurs to me here is that it is not crucial to make money at every market turn, but it is exceedingly important not to lose it!

From the standpoint of the big picture, I maintain that we are still in a primary bull market, and in the second psychological phase of that bull market. I have been writing (ever since the bull market began) that the second psychological phase is the deceptive phase, the “hair puller.” So far this bull market is obviously running very much true to form.

When the 1949-66 bull market went into its second phase (which was 1954-57) we had a beautiful ride up (1954 to 1956) and then two years (1956-57) which tried everyone’s patience and then tried their pocketbooks (via the 1957 smash). I’ve wondered whether we are not now going through the period comparable to 1956-57. At that time, the Dow formed a most perplexing “triple-top” at the 520-521 level, then broke down to 419 in late-1957.

At any rate, if today’s second phase of the bull market continues to run true to form, we should hit a rather costly reaction somewhere ahead (at which time everyone will cry “bear market.”) This should be followed by the final, speculative third phase. But let’s take one thing at a time, and we’re still in the “perplexing second phase” at present.

I don’t see any “easy profits” from this point on in the second phase, but I do see more difficulties, more divergence movements, and fewer and fewer stocks responding to good news. The big stocks, the Dow stocks, are obviously looking at something that few of us can pin-point or discern. Maybe it is this: Ed Wilson of *John Muir & Co.* runs comparative studies on profit margins of 100 major corporations. He notes that in the first quarter of 1977 48% of the companies showed **lower profit margins**. This was up from 44% in the last quarter of 1976, and from 39% in the third quarter of ‘76. Thus half the companies are now being squeezed on profit margins. In my book, that suggests a general profit squeeze coming. Only increasing volume is holding actual profits up.

As this is written the Dow continues to hover above the 898.66 level with the Transports floating above their comparable 235.05 mark. Big volume is coming into the market. In the face of the lagging Averages, the A-D ratio and the Primary Trend Index (PTI) are at new bull market highs, a remarkable performance. I don’t remember the Dow ever having topped out ahead of both the bond market and the London market and the A-D ratio, so we are dealing with a Wall Street situation of a highly unorthodox nature.

MONEY NOTES: Of the no-load bond income (taxable) funds, the highest yielder at present (on an annualized basis) is *Northeast Investor’s* (50 Congress St., Boston, Mass 02100) with a yield of 8.6%. In second place is *Price New Income* with a 7.7% yield. In the tax exempt no-load category, the leader this year on a yield basis is *Fidelity Municipal Bond Fund* (83 Devonshire St., Boston, Mass 02103) with a 5.43% yield. In second place is the *Price Tax Free Fund* with a yield of 5.35%.

NEXT MAILING: July 29th